No. 8431

In the United States Circuit Court of Appeals for the Ninth Circuit

BISHOP TRUST COMPANY, LIMITED, AND MR. ARTHUR BERG, TRUSTEES, MAUDE G. YOUNG TRUST, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The only previous opinion in this case is that of the United States Board of Tax Appeals (R. 33–40), which is not reported.

JURISDICTION

This appeal involves income taxes for the year 1932 in the sum of $712.51, and is taken from a decision of the Board of Tax Appeals entered August 11, 1936 (R. 41). The case is brought to this Court by petition for review filed November 9, 1936 (R. 42–49), pursuant to the provisions of Sections

1001–1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169.

QUESTION PRESENTED

Whether the sum of $12,000 paid in 1932 by the trustees to the beneficiaries of the testamentary trust constitutes an allowable deduction from the gross income of the trust for such year.

STATUTES INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 161. IMPOSITION OF TAX.
>
> (a) *Application of tax.*—The taxes imposed by this title upon individuals shall apply to the income of estates or of any kind of property held in trust, including—
>
> (1) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;
>
> (2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;
>
> (3) Income received by estates of deceased persons during the period of administration or settlement of the estate; and
>
> (4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

SEC. 162. NET INCOME.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

* * * * *

(b) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. Any amount allowed as a deduction under this paragraph shall not be allowed as a deduction under subsection (c) of this section in the same or any succeeding taxable year;

* * * * *

STATEMENT

The facts were stipulated (R. 18–33). Maude G. Young, widow, died testate on October 3, 1926, a resident of Honolulu, Territory of Hawaii, and was survived by two children, Alice Pauline Young MacRae and Nelson Gillett Young (R. 19). The will of decedent (R. 24–33) was admitted to probate in the Circuit Court of the First Judicial Circuit, Territory of Hawaii, and letters testamentary

were issued on November 15, 1926, to Bishop Trust Company, Limited, and Arthur Berg as executors (R. 19). On December 20, 1926, the executors qualified as and were appointed trustees under the will of the Maude G. Young trust (R. 19–20). On June 1, 1934, Arthur Berg, one of the cotrustees, died and Nelson Gillett Young was duly appointed successor cotrustee (R. 20).

Pertinent excerpts from the will are set forth below (R. 24–25, 26–27, 29, 30):

> First. I direct my Executors to pay all my just debts and funeral and administration expenses and also all estate, inheritance, succession, and transfer taxes on all devises and bequests given hereby and also the cash legacies given hereby, out of the cash principal of my estate at the time of my death and the proceeds of sales of my bonds and real estate and the surplus net income over the amount payable to my daughter and son as hereinafter provided, without selling any of my corporation stocks. If my Executors shall not be able to complete all said payments out of cash derived from said sources within a reasonable time I authorize my Executors to complete the administration of my estate and to transfer and deliver the residue of my property as hereinafter provided to my Trustees hereinafter named, charged with the payment of said cash legacies, and I authorize my said Trustees to accept said residue so charged with said cash

legacies and to pay the same out of the surplus net income of my trust estate. * * *

* * * * *

NINTH: I give, devise, and bequeath all of the rest, residue and remainder of my property, both real and personal, wherever situated and of whatever nature, to *Bishop Trust Company, Limited,* a Hawaiian corporation, and *Arthur Berg* of Honolulu, Territory of Hawaii, as Trustees, to have and to hold the same to them and their successors in trust upon the following trusts:

(a) To pay to my daughter, Alice Pauline Young MacRae, wife of Herbert Bennett MacRae, the sum of Five Hundred Dollars ($500) each and every month in advance on the first day of the month, beginning as of the date of my death and making the first payment as soon as possible after my death, until she and my son, Nelson Gillet Young, shall both have attained the age of thirty-five (35) years or died;

(b) To pay to my son, Nelson Gillet Young, the sum of Two Hundred Fifty Dollars ($250) each and every month in advance on the first day of the month, beginning as of the date of my death and making the first payment as soon as possible after my death, until he shall attain the age of twenty-five (25) years or until his marriage or death, whichever event shall happen first, and thereafter to pay to him, if surviving, the sum of Five Hundred Dollars ($500) each and every month in advance on the first

day of the month until he and my daughter, Alice Pauline Young MacRae, shall both have attained the age of thirty-five (35) years or died.

* * * * *

(f) I hereby authorize my Trustees to pay to my daughter or son or to use and apply for her or his benefit prior to the distribution of the principal, portions of the income or accumulated income derived from the trust estate in addition to the amounts hereinabove set forth if and whenever in their discretion such additional income shall be needed by her or him because of illness or for any other special cause or purpose. * * *

* * * * *

(i) My said Trustees shall have the power to sell at public or private sale, lease for terms not exceeding thirty (30) years, which leases shall be valid throughout their terms notwithstanding the prior termination of the trust, convert, mortgage, hypothecate and otherwise deal in any manner with all real estate and personal property forming the principal of said trust estate, with full powers with reference to the management thereof, and to invest the proceeds thereof, with like power of sale, disposition and investment from time to time in the discretion of said Trustees, * * *.

During the calendar year 1932, the income from the corpus of the trust exceeded the payments made to the beneficiaries (R. 37).

In accordance with the will, the trustees made the twelve monthly payments of $500 each to the two children of the decedent, and in their return for such year claimed a deduction of the $12,000 so distributed (R. 38).

The Board of Tax Appeals sustained the action of the Commissioner of Internal Revenue in disallowing such deduction.

SUMMARY OF ARGUMENT

The pertinent statute provides that the amount of currently distributable income of a trust shall be allowed as a deduction to the trustee, but that such amount shall be included in computing the net income of the beneficiary. The Supreme Court has held that where the payments are to be made to the beneficiary in any event and not expressly conditioned upon the sufficiency of current income, then the payments are in the nature of fixed charges or legacies and are neither taxable as income in the hands of the beneficiary nor allowable as deductions to the trustee. The fact that the payments were to be made first out of income and that the income in the year in question was sufficient to meet all the payments does not alter the rule.

In the case at bar, the testamentary trust provided for the monthly payment of $500 each to the decedent's two children, without limiting the payments to income from the corpus. While the decedent, no doubt, *contemplated* that the income from the corpus would be sufficient to meet the

monthly payments, she did not *direct* that they be so limited. Construing the whole will, the Board of Tax Appeals correctly concluded that the decedent intended that the monthly payments be made to her children in any event, and accordingly constituted fixed charges against the corpus and were not deductible as distributions of income by the trustees.

ARGUMENT

The payments to be made to the beneficiaries of the testamentary trust constituted a fixed charge against the corpus and are not deductible in computing the net income of the trust

Pursuant to the terms of the will of Maude Gillett Young, the trustees paid during the taxable year 1932 the sum of $12,000 to the beneficiaries of the trust. The claim is made that this was a distribution of income, deductible as such, within the meaning of Section 162 (b), *supra.*

It is now settled that if payments to beneficiaries of an estate or trust are payable at all events and are not limited to payment out of income they are not deductible in computing the net income of the estate or trust and are not taxable to the beneficiaries. *Helvering* v. *Pardee,* 290 U. S. 365, 370; *Burnet* v. *Whitehouse,* 283 U. S. 148. On the other hand, where the payments are to be made only from income and the corpus may not be invaded to meet same, they are deductible by the estate or trust and are taxable to the beneficiaries. *Helvering* v. *But-*

terworth, 290 U. S. 365; *Irwin* v. *Gavit,* 268 U. S. 161.

The plain purpose of the statute is to tax annually the entire net income of all trust estates, either to the fiduciary or to the beneficiaries or partly to each. *Freuler* v. *Helvering,* 291 U. S. 35, 41; *Helvering* v. *Butterworth, supra* (p. 369). Primarily, such income is taxable to the fiduciary, but to the extent that the income is to be distributed currently, the fiduciary is allowed an additional deduction and the amount thereof is taxable to the beneficiary to whom it is distributable. It is clear, however, that the additional deduction authorized to the fiduciary is only of income which is distributable as such to the beneficiary. The statute does not tax as income the value of property acquired by gift, bequest, devise, or descent and accordingly the payment by a testamentary trustee of a bequest, not merely of income but of a fixed amount at all events, is not an allowable deduction in computing the taxable net income of the trust. *Helvering* v. *Butterworth, supra* (p. 370); *Burnet* v. *Whitehouse, supra.*

In paragraph 9 of her will (R. 26–27), the testatrix bequeathed the residue of her estate in trust upon the following trusts:

> (a) To pay to my daughter, Alice Pauline Young MacRae, wife of Herbert Bennett MacRae, the sum of Five Hundred Dollars ($500) each and every month in advance on the first day of the month, beginning as of

> the date of my death and making the first payment as soon as possible after my death, until she and my son, Nelson Gillet Young, shall both have attained the age of thirty-five (35) years or died; * * *.

A similar provision was made for the benefit of the son (R. 27).

Counsel for petitioners contends in his brief (pp. 11–32) that since the source of the payments to be made to the two beneficiaries is not specifically designated in the will, the intention of the testatrix as to the source of the payments must be ascertained by construing the will as a whole, and he cites a number of passages from the will which he says shows that it was the intention that the payments should be made only from income.

On page twelve of their brief, petitioners stress the point that there is no express provision in the will that the monthly payments be made out of the corpus or were to be paid in any event. We submit that the natural assumption is that where provision is made for monthly payments to the decedent's own children, they are to be made in any event and are not to be conditioned upon the sufficiency of current income unless expressly so directed.

On page fifteen of their brief, petitioners contend that the construction of the whole will discloses that the testatrix *intended* that the monthly payments be made only from income. Doubtless, the testatrix did intend, in the sense of contemplate,

that the current income would be sufficient to meet the payments, but she deliberately refrained from directing that the payments be made only from income. A comparison of the language used by the testatrix in providing for the regular monthly payments (R. 26–27) with that used by her in providing for certain extra payments (R. 29) indicates that we used the word "deliberately" advisedly. We submit that petitioners' argument (Br. 22–23) that the additional payments in case of emergency were expressly conditioned upon the sufficiency of income, in effect, supports the Government's theory. The choice of language in this and other sections of the will clearly shows that the testatrix knew how to limit or condition the payments when she so desired, and further substantiates the natural assumption that, in the absence of such an express condition or limitation, the stipulated payments were to be made in any event.

The petitioners contend (Br. 25) that because the trustees were directed to pay the collateral legacies only out of accumulated income, the testatrix evidently desired that the monthly payments to the children should not reduce the principal of the trust. This, we submit, involves an obvious *non sequitur*. Here again we see a difference in the choice of language. Was it not logical for the testatrix to want the payments to collateral heirs made only out of available cash or accumulated income, and yet to desire that the payments to her own children be made regularly in any event?

The petitioners further point (Br. 27) to the spendthrift provision of the will (R. 30) as showing that the testatrix intended that none of the principal of the estate be reached during the period in question. We submit that this provision merely shows that the decedent wanted her children taken care of in any event, regardless of anxious creditors or disgruntled spouses. This provision supports our view that, in point of law, the payments were to be made regularly to the children in any event.

The cases cited by the petitioners (Br. 28–30) are not determinative of the question whether there was a legal ability to go beyond the current income if necessary in making the monthly payments, but were merely concerned with the practical problem of likelihood of such action being necessary. The courts were construing the effect of a remainder interest rather than the nature of the primary interest of the annuitants. The courts were there facing different problems and were approaching the issues with a different point of view. We are here concerned with the application of a Federal tax statute and not with the settlement of disputes between rival claimants for testamentary funds. The rule as to tax cases has been clearly enunciated by the Supreme Court, and the state court decisions relied upon by the petitioners are inapplicable.

In *Helvering* v. *Pardee, supra,* the Supreme Court pointed out that the quarterly payments were payable at all events, since they were not made

dependent upon income from the trust estate. In other words, since the payments were not necessarily limited to income, they constituted a charge upon the estate as a whole, and accordingly were not distributions of income deductible as such by the trustee but were payments in discharge of a trust or legacy.

In *Burnet* v. *Whitehouse, supra,* the Supreme Court has said that the statute providing for the taxing of distributable income in the hands of the beneficiary applies only to income paid as such to a beneficiary. The annuity in that case was paid out of income of the corpus. However, under the terms of the will, the executor was authorized to set aside and hold any part of the personal property to provide for the payment of the annuity. The argument of the Government in that case closely parallels that of the petitioners here: (1) That generally speaking an annuity given by a will is payable primarily out of the income of the estate; (2) that the estate actually produced sufficient income to meet the annuities; (3) and that the payments received were in fact from the income. The Supreme Court answered this line of argument by saying that it would be an anomaly to tax one year and exempt another simply because executors paid the first from income received and the second out of the corpus. The court pointed to the fact that the will directed payment without reference to the existence or absence of income and concluded that this was controlling.

The above cases were followed and the deduction disallowed where an annuity to the testator's wife was to be paid out of income, or if the income was insufficient, from corpus, although for the years involved the payments were actually made from income. *Bridgeport-City Trust Co.* v. *Commissioner,* 84 F. (2d) 991 (C. C. A. 2d), affirming, *per curiam,* the decision of the Board of Tax Appeals reported in 32 B. T. A. 1181.

In other words, it is not enough to show that the payments in the year in question were in fact made from income or even that the decedent contemplated that the income from the corpus would be sufficient to provide for the regular payments. We are here concerned with the legal effect of the will. Thus, the issue is not whether the distribution was actually made from the current income, but whether it was the wish of the testatrix that the payments be made in any event, without being conditioned upon the sufficiency of income. Since there is in this case an unlimited direction to pay the monthly allowances in advance, without reference to the sufficiency of income, we must assume that the decedent, while possibly contemplating that the income would be sufficient, likewise contemplated that if the income from the corpus did fall short in any particular period, then the allowances were to be paid in any event, from the corpus if necessary.

It seems clear that the predominant purpose of the testatrix was that her two children should have a steady monthly income in the nature of an an-

nuity from the day of her death until the trust terminated. The directions to the trustees contained in subparagraphs (a) and (b) of paragraph 9 of the will (R. 27) were to make the specified payments each and every month in advance of the first day of the month. These directions are specific and leave nothing to inference. Nothing could be more certain than that the testatrix wanted to make sure that the two children would receive the sums regularly and promptly. This seems inconsistent with an intention that the payments were to be made only from income as contended by opposing counsel. While the trust estate was not small, there was no assurance that it would receive sufficient income to meet the monthly payments and conceivably it might not have any income at all over a long period of time, dependent, as it was, primarily upon corporate dividends. In view of the very specific direction that the sums be paid each and every month in advance, it is not believed that the testatrix intended that the payments should be passed if there was not sufficient income to meet them. Another thing which makes it appear that it was the intention of the testatrix that the payments were to be made at all events is the fact that she specified that they were to be made *monthly in advance.* There is not only no showing that the trust received its income monthly, but on the contrary practically all the income it did receive was in the form of dividends which are not generally pail until the end of the year or at least not

more often than semiannually. It is quite possible, therefore, that the trustees could not have made the payments monthly in advance unless they could resort to the corpus of the trust. Under paragraph 9 (i) of the will (R. 30–31), the trustees were given full power to sell or trade any of the corpus of the trust. The petitioners' reference (Br. 37, 43) to the prohibition against selling the securities was effective only as to the executors (R. 24).

The various passages of the will in which the testatrix speaks of the income of the trust and which counsel for petitioner relies on in support of his contention that the will should be so construed as to require the monthly payments to be made only from income (Br. 15–27) do not, in our opinion, mean anything more than that the testatrix, at the time she executed the will, *anticipated* that there would be more than enough income realized by the trust estate to meet the monthly payments. The estate was a fairly large one and it was logical to assume that it would earn more than $12,000 per year above expenses, and it was only natural for the testatrix to make mention of and provide for the disposition of any surplus net income that was realized as she did, for instance, in paragraph 9 (f) of the will (R. 29). It is difficult to believe, however, in view of the specific directions in subparagraphs (a) and (b) of paragraph 9 to pay the amounts each and every month in advance on the first day of the month, without the source of the

payments being designated, that the testatrix could have intended that the trustees were to make the payments only if, as, and when sufficient income was realized to make it possible to do so. This is particularly true when it is considered that the beneficiaries of the payments were the two children of the testatrix and were to receive the entire estate after the termination of the trust, and hence there was no conflicting interests as between the beneficiaries and the remaindermen. Obviously, the provisions for the two children were for their maintenance and support, and it is not logical to say that the testatrix intended that they should go without funds sufficient to maintain them according to their station unless the trust estate produced sufficient income which could be used for such purpose. The view that the payments were for the maintenance and support of the two children is strengthened by the fact that it was specified that (R. 27) they were to begin as of date of death of the testatrix and by the provisions against alienation or hypothecation (R. 30).

An annuity is a stated sum payable periodically but not necessarily annually. The distinction between a gift of income and an annuity is that the former embraces only the net profit after deducting all necessary expenses, whereas the latter is a fixed amount directed to be paid absolutely. *Peck* v. *Kinney,* 143 Fed. 76 (C. C. A. 2d). The testatrix directed the trustees to pay the children a fixed

amount each and every month for a definite period of time without specifying any particular fund out of which the payments were to be met. The directions were couched in language as clear, definite, and explicit as it is possible to make it. There can be little question but that the testatrix created, and intended to create, a pure annuity in favor of her children and did not merely make them a gift of income.

In view of the foregoing, it is submitted that the payments in question did not constitute income of the trust to be distributed currently by the fiduciary to the beneficiaries and that the deduction claimed therefor is not allowable in accordance with the decisions of the Supreme Court in *Helvering* v. *Pardee,* and *Burnet* v. *Whitehouse, supra.*

CONCLUSION

The decision of the Board of Tax Appeals is correct and should be affirmed.

Respectfully submitted.

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